

ON THE ISSUANCE OF ISLAMIC SECURITIES BY
STATE AND LOCAL GOVERNMENTS; OR, WHY NEW
JERSEY SHOULD SELL THE TURNPIKE TO THE EMIR
OF DUBAI

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Over the past decade, interest in Islamic finance, and particularly securities compliant with Islamic law, has increased dramatically. With the increasing wealth of Muslims both in the traditional “Muslim world” and elsewhere, we can reasonably expect Islamic finance to be a growing market for the foreseeable future as religious Muslims seek to build wealth and finance business operations in compliance with the prescriptions of Sharia (Islamic law). Even non-Muslim financial institutions and governments have taken an interest in providing Sharia-compliant financial products, hoping to tap into a potentially vast pool of new capital.

Among the primary vessels by which institutions seeking to enter this market—both Muslim ones, like the expressly created Islamic banks, and more conventional ones with no particular commitment to Islam—are *sukuk*. *Sukuk*¹ are financial certificates, typically likened to conventional bonds, and much like bonds they are sold by a person or an institution seeking to raise capital.² They may be, and often are, purchased on the secondary market, and pay to the bearer “interest” at regular intervals and the principal upon maturation.³ The private market for *sukuk* outside the Muslim world has been expanding for some time, and has been established in the United States since 2006, when some Muslim investors from the Persian Gulf purchased *sukuk* for a

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¹ The word is plural; the singular is *sakk*, from an Arabic word meaning “(instrument of) contract . . . legal instrument, document, deed, check.” See HANS WEHR, A DICTIONARY OF MODERN WRITTEN ARABIC 520 (J. M. Cowan ed., 3d ed. 1976).

² Ayman H. Abdel-Khaleq & Christopher F. Richardson, *New Horizons for Islamic Securities: Emerging Trends in Sukuk Offerings*, 7 CHI. J. INT’L L. 409, 409 (2007).

³ *Id.* at 412, 414.

venture to drill for oil in the Gulf of Mexico.⁴ Internationally, Western countries—particularly the United Kingdom—have taken an interest in encouraging and regulating the *sukuk* market.

As noted above, governments as well as private parties in need of capital can issue *sukuk*. For some Muslim countries, *sukuk* are a common way of getting financing; for others, a *sukuk* issue is rare (e.g. Egypt in 2012-13, where a planned *sukuk* issue by the Muslim Brotherhood government of then-President Mohamed Morsi was significant news and treated by some as cause for concern).⁵ Moreover, there is no prohibition in Islamic law against non-Muslims issuing *sukuk* or against Muslims purchasing such *sukuk*, so long as the funds do not support activities forbidden by Islamic law (e.g. gambling or the sale of pork products or alcohol). Thus, it is not inconceivable that, were a Western government to issue *sukuk* (or other financial instruments compliant with Islamic law), Muslims would be willing to buy them. Indeed, the government of the United Kingdom has been considering just such an issue since 2011, hoping that it would help London become a major international center for trading in *sukuk*, and Islamic finance more generally.⁶

With what appears to be a bonanza to be had in the market for *sukuk*, one is left to wonder: why does the United States not get a move on this? If London could conceivably be a center of Islamic finance, why not New York? Why not encourage the development of this market? For that matter, why not participate in this market—if not by the federal Treasury, then perhaps by the states, or by the numerous municipalities in this country in need of capital?

There are numerous factors that disfavor the participation of American governments—be they federal, state, or local—in the Islamic finance market, ranging from the politics and optics of such participation to simple inertia; but perhaps one of the most critical issues in the growth of Islamic finance in the United States is legal—specifically, constitutional. The Establishment Clause of the First Amendment to the U.S. Constitution—and similar provisions in state constitutions across the country—necessarily make the prospect of both regulating and issuing *sukuk* a far riskier prospect than, say, in Britain, where such regulation or

⁴ *Id.* at 414.

⁵ Maggie Hyde, *Government Struggles to Get a Sukuk Law on the Books*, EGYPT INDEP. (Jan. 18, 2013, 4:33 PM), <http://www.egyptindependent.com/news/government-struggles-get-sukuk-law-books>.

⁶ A. R., *A Mecca for Sukuk*, THE ECONOMIST (Nov. 1, 2013, 12:40 PM), <http://www.economist.com/blogs/schumpeter/2013/11/islamic-finance>.

issue would not be potentially challengeable in court as an impermissible preference for one religion over another.

Authors have written about the potential constitutionality or unconstitutionality of regulating the market for privately issued *sukuk*. On one hand, Leonard Grunstein, one of the few to write in opposition to the expansion of *sukuk* in the U.S. market, has argued that regulating *sukuk* is unconstitutional.⁷ He explains that regulation necessarily requires the government—through legislation, regulation, or the courts—to in effect rule on the “Islamicity” of the regulated *sukuk*, which would face both Free Exercise Clause and Establishment Clause issues.⁸ Specifically, the regulation of the Islamic financial market would necessarily require compliance standards to insure that the instruments comply with the various prohibitions against *riba* (interest/usury), support of un-Islamic activities, and so on, which would necessarily be interpreted by the courts. This the courts cannot do. The Supreme Court’s jurisprudence on the matter is clear: in *Presbyterian Church in the U.S. v. Mary Blue Hull Memorial Presbyterian Church*,⁹ it is that where a dispute depends on the meaning of religion, the secular courts should refrain from decision.¹⁰ On the other hand, several authors have written about the vast potential for the United States to engage in the Islamic securities market,¹¹ and a few have argued that the concerns about “ruling” on issues of religious law are weakened when the religious laws concern commercial activity.¹²

On the other hand, there is little or nothing in the legal literature regarding the constitutionality of American governments *issuing* Islamic financial instruments. Although the

⁷ Leonard Grunstein, *Interest, Ribit, and Riba: Must These Disparate Concepts be Integrated or is a More Nuanced Approach Appropriate for the Global Finance Community?* (pts. I-III), 130 BANKING L. J. 439, 537, 745 (2013)

⁸ *Id.*

⁹ *Presbyterian Church in the U.S. v. Mary Elizabeth Blue Hull Mem’l Presbyterian Church*, 393 U.S. 440 (1969).

¹⁰ *Presbyterian Church* 393 U.S. at 449. The case arose out of a dispute between the national Presbyterian Church and a local congregation about the disposition of the congregation’s church building when the congregation chose to disaffiliate from the national Church. The congregation argued that they were entitled to keep their property, as (according to the congregation) the national Church had strayed from true Presbyterian doctrine. *Id.* at 442–43.

¹¹ See, e.g., Todd J. Schmid, Note, *The Real Shariah Risk: Why the United States Cannot Afford to Miss the Islamic Finance Moment*, 2013 U. ILL. L. REV. 1293 (2013), and Mushfique Shams Billah, Comment, *Arab Money: Why Isn’t the United States Getting Any?* 32 U. PA. J. INT’L L. 1055 (2011).

¹² Michael A. Helfand, *Fighting for the Debtor’s Soul: Regulating Religious Commercial Conduct*, 19 GEO. MASON L. REV. 157, 160 (2011).

issues are related, they are sufficiently distinct to present different constitutional and other legal issues. Government issue of *sukuk* does not raise the same concern about the secular courts (or administrative agencies) interpreting religious law that regulation might raise. Rather, the government, in issuing *sukuk*, would simply be presenting to the market a product that happens to conform to Islamic law. To use an analogy, a government issue of *sukuk* is not like the state being called upon to decide whether a particular piece of meat is kosher. Instead, it is like the state purchasing certified kosher meat from a kosher butcher and using it at a formal dinner, at which observant Jewish guests are expected to attend. The government does not here interpret religious law itself; it merely conforms its actions to an external interpretation of religious law, and informs those who care of that conformity.

This is not to say that government issue of *sukuk* in the United States is not without potential legal pitfalls. On a constitutional level, the current understanding of the Establishment Clause bars the “endorsement” of any religion over any other; thus one question a government subject to the Establishment Clause seeking to issue *sukuk* would have to ask is whether the issue would “endorse” Islam.¹³ Finally, even if there are no legal or religious bars to a government issue of *sukuk*, what liabilities would an issuing government and *sukuk* holders face as compared to issuers and holders of conventional bonds? It is these questions I intend to explore in this note.

I. A BRIEF INTRODUCTION TO *SUKUK*

In order to understand the constitutional issues and other possible liabilities raised by the governmental issue of *sukuk*, we

¹³ See also Shams Billah, *supra* note 11, at 1092–94 (noting the existence, but not the substance, of Establishment Clause issues in the Islamic finance context). Other issues arise with respect to Islamic law. Many states engage in the sale of alcohol (e.g. Pennsylvania), and most run lotteries. See *Frequently Asked Questions*, PA. LIQUOR CONTROL BD., <http://www.lcb.state.pa.us/PLCB/About/FAQs/index.htm> (last visited Mar. 14 2015); Kim Chandler, *Which States Don't Have a Lottery? One Might Surprise You*, AL.COM (Dec. 31, 2013, 7:39 AM), http://blog.al.com/wire/2013/12/which_states_dont_have_a_lotte.html.

Sukuk cannot be backed by an “immoral” venture, i.e. one prohibited by Islamic law. See Abdel-Khaleq & Richardson, *supra* note 2, at 411. The permissibility or impermissibility of purchasing state-issued *sukuk* on these grounds may vary among *ulama* (Islamic scholars), as there is an issue of whether the funds will “support” these forbidden ventures or not given the complexities of state finances; as an analysis of this variation could constitute an entire article unto itself, this issue will be set aside for the purposes of this note.

must first understand what *sukuk* are and how they differ from conventional bonds.

The first clear difference between *sukuk* and more conventional forms of finance is that *sukuk* are structured to avoid a specific religious prohibition—namely, the Islamic prohibition on *riba*.¹⁴ *Riba* is often translated as “usury,” but this does not quite capture the character of the prohibition; under Islamic law, *any* charging of interest is apparently usurious.¹⁵ On the other hand, the translation of *riba* to mean “charging interest,” has also been challenged; that said, it is the closest concept for our purposes.¹⁶ In any case, however, the traditional structure of a bond—as a loan on which the issuer pays the bondholder interest—is right out.

However, although *riba* is forbidden, *bai`*—“trade”—and *ribh*—“profit”—are not.¹⁷ This line can be fine, but in general this means that *sukuk* are typically asset-backed—they are tied to the value of some, at least partially tangible asset, in which the holder of the security directly owns a stake in the underlying property.¹⁸ What that asset is, or how tangible it is, is of no concern. Under a widely-followed interpretation from the Accounting and Auditing Organization for Islamic Financial Institutions, *sukuk* may be based on a number of different kinds of assets, including tangible assets, usufructs, and services.¹⁹ So long as the requirement of being asset-based is satisfied, there are many ways to structure *sukuk*.

The most common and most basic kind of *sukuk* is *sukuk al-ijarah*—*sukuk* of lease. This is the usual manner in which *sukuk* are structured.²⁰ In the most basic form of an *ijarah*, the borrower must first identify the underlying asset on which the *sukuk* are to be based.²¹ In a modern *ijarah*, the party typically establishes a

¹⁴ Abdel-Khaleq & Richardson, *supra* note 2, at 411. *See also* Qur’an 3:130 (“O ye who believe! Devour not usury, doubled and multiplied; but fear Allah; that ye may (really) prosper.”).

¹⁵ Grunstein, *supra* note 7, at 440.

¹⁶ *Id.* Grunstein argues that the concept of *riba* cannot be properly encompassed by the concept of interest, in part on account of the moral implications of *riba*. However, most English translations of the Qur’an use the term “usury” where the original Arabic has *riba*, and for the purposes of this note the distinction is mostly irrelevant.

¹⁷ *See, e.g.,* Qur’an 2:275 (“God hath permitted trade but forbidden usury.”).

¹⁸ Grunstein, *supra* note 7, at 547.

¹⁹ Michael J. T. McMillen, *Islamic Capital Markets for United States Parties: Overview and Select Shari’ah Governance Elements*, 2013 WL 5293295, *13 (Aug. 2013).

²⁰ Grunstein, *supra* note 7, at 547–48.

²¹ DUBAI INTERNATIONAL FINANCE CENTRE, DUBAI INTERNATIONAL FINANCE CENTRE SUKUK GUIDEBOOK 14 (2009), available at <http://www.difc.ae/sites/default/>

special-purpose vehicle (SPV) to issue the *sukuk*, which represents an ownership interest in the asset, and also represents certain rights against the SPV.²² Upon sale of the *sukuk*, the SPV then becomes the trustee over the proceeds.²³ The SPV in turn purchases, as trustee, the asset from the borrower for an agreed price.²⁴ The purchase price of the asset is, in effect, the principal of the loan.²⁵ The SPV then leases the asset back to the borrower, who pays a rate of rental that may be fixed or variable—in effect, the interest—and agrees on an exercise price at which the borrower will purchase the asset back from the trustee (equivalent to the return of principal on a bond).²⁶ At maturity, default, or (if applicable) upon the debtor’s exercise of a call option, the debtor repurchases the assets and the pre-agreed amount to be distributed is given to the investors.²⁷

There are a variety of other mechanisms, but ultimately they are variations on this theme. For *sukuk al-musharakah*—*sukuk* of partnership—the SPV is not a party to a lease-and-buyback agreement, but a partnership or joint venture;²⁸ for *sukuk al-murabahah*—*sukuk* of profit-making—the asset is a commodity transaction;²⁹ for *sukuk al-mudarabah*, literally *sukuk* of sweat-capital, it is an equity-partnership agreement by the borrower to “manage” a business for the lender.³⁰ Different *sukuk* structures have different uses. For instance, if the underlying assets are hard to identify, a *musharakah* or *mudarabah* agreement might be preferable to the more common *ijarah*.³¹ And since these different forms of *sukuk* are based on different legal structures, they may present different liabilities; the extent to which these different liabilities affect government *sukuk* will be addressed later in this note.

files/attached/5712/6707/6429/islamic.pdf.

²² *Id.*; The SPV is a modern innovation and was unknown in historical *sukuk al-ijarah* issues; however, these traditional *ijarah* arrangements do not concern us here.

²³ *Id.*

²⁴ *Id.* at 14–15.

²⁵ *Id.* at 15.

²⁶ DUBAI INTERNATIONAL FINANCE CENTRE, *supra* note 21, at 15.

²⁷ *Id.*

²⁸ *Id.* at 20.

²⁹ *Id.* at 46.

³⁰ *Id.* at 28.

³¹ DUBAI INTERNATIONAL FINANCE CENTRE, *supra* note 21, at 20, 28.

A. Sovereign Sukuk

One good way of illustrating the manner in which *sukuk* are structured—and with direct bearing on our topic of inquiry—is the structure of sovereign *sukuk* abroad. Several Muslim countries issue their “debt” in the form of *sukuk*; indeed, so many do as of 2012, that the vast majority of *sukuk* issued to the market were either sovereign *sukuk* or *sukuk* issued by state-related entities.³² Since our point of inquiry is how governments in the United States might participate in the *sukuk* market, it would also be useful to see how an American government—be it federal, state, or local—might structure a hypothetical *sukuk* issue.

One government that makes use of *sukuk* is Malaysia. The Malaysian model of sovereign *sukuk* is an *ijarah* structure, using lands owned by the government as the underlying asset.³³ For its first issue of international-market sovereign *sukuk* in 2002, Malaysia’s federal government established a special-purpose corporation in order to sell *sukuk*.³⁴ The funds raised by the sale were then used to effect the purchase of title to the selected lands.³⁵ However, rather than transfer the title in fee simple, the government granted the corporation beneficial title, with the federal government retaining recorded title “in trust” for the corporation, avoiding the need to formally record title or pay certain taxes.³⁶ This arrangement, although perhaps historically unusual, has become more or less commonplace in the issue of sovereign *sukuk*.³⁷

The actual asset sold need not be anything in particular; indeed, it need not have any inherent income-generating capacity at all.³⁸ Pakistan and the United Arab Emirates constituent

³² McMillen, *supra* note 19, at *15. This appears to be a new development; in 2007, a majority of *sukuk* offerings were reported to be corporate rather than sovereign, although that figure did include some state-related corporations. See Abdel-Khaleq & Richardson, *supra* note 2, at 413–14.

³³ A. Roger Wedderburn-Day, *Sovereign Sukuk: Adaptation and Innovation*, 73 LAW & CONTEMP. PROBS. 325, 327 (2010).

³⁴ *Id.*

³⁵ *Id.*

³⁶ *Id.*

³⁷ *Id.* at 326-27 (referring to the Malaysian *sukuk* structure as an “innovation” needed to encourage wider acceptance of the transaction).

³⁸ Grunstein, *supra* note 7, at 547-48. As Grunstein notes, this ultimately means that the non-interest nature of the transaction is a mere sham—in the usual case where the underlying asset is real estate, the amount of “rent” paid is allowed to take into account various costs, which conveniently add up to equal a competitive rate of interest. *Id.* For this reason, some more conservative Muslims are suspicious of *ijarah* arrangements, and some *ulama* hold them to be non-

emirate of Ras al-Khaima have both used roads as the underlying asset.³⁹ Bahrain has used a vacant patch of land next to the airport.⁴⁰ An early Western adopter of the *sukuk* structure, the German State of Saxony-Anhalt, used a portfolio of government lands held by a Dutch-law trust to back its 2004 issue.⁴¹ Since these lands often have no intrinsic value, this has raised certain suspicions from an Islamic perspective that the *ijarah* arrangement is an impermissible sham,⁴² but nevertheless, the *ijarah* structure is the norm for sovereign *sukuk* issues, and is thus the most likely to be adopted should any U.S. entity attempt to enter this market.

Of course, these details aside, that leaves the question of *why* a government would issue sovereign *sukuk*. Thus far, governments issuing or considering issuing *sukuk* have fallen into two categories: 1.) Governments that have some kind of official or political commitment to Islam and want to move their countries in the direction of Islamic finance. A good example is Turkey, where analysts generally believe *sukuk* issues were motivated by the policy preferences of the Islamist AK Party government.⁴³ 2.) Governments seeking to expand their access to new potential sources of capital and encourage the growth of Islamic finance as one sector of a diversified financial market. Britain's plans to issue *sukuk* fall squarely into this category.⁴⁴

Obviously, no government in the United States could legitimately pursue the first policy, and even if it could, it would be politically impossible. However, the second goal—making the United States a better environment for Islamic finance—will attract capital from a large sector of investors with substantial

compliant outright. See, e.g., Dr. Monzer Kahf, *Ijarah Loans: Permissible?*, ONISLAM (Apr. 3, 2013), <http://www.onislam.net/english/ask-the-scholar/financial-issues/finance-and-banking/462088-ijarah-and-zakah-a-closer-view.html> (in response to a private Muslim's question about *ijarah* loans, and referring to a past ruling that they are impermissible).

³⁹ Wedderburn-Day, *supra* note 33, at 330.

⁴⁰ *Id.* at 329.

⁴¹ Abdel-Khaleq & Richardson, *supra* note 2, at 415.

⁴² See, e.g., Kahf, *supra* note 38.

⁴³ Seda Sezer & Bernardo Vizcaino, *Mideast Debt-Turkey Embraces Islamic Finance with Sovereign Sukuk*, REUTERS (Sept. 19, 2012, 10:00 AM), <http://www.reuters.com/article/2012/09/19/turkey-islamic-finance-idUSL5E8KG1CQ20120919>.

⁴⁴ James Phillipps, *Chancellor Osborne to Launch First Sharia Bond*, CITYWIRE (Oct. 29, 2013 7:57 AM) <http://citywire.co.uk/wealth-manager/news/chancellor-osborne-to-launch-first-sharia-bond/a712880>.

resources, but for religious or political reasons cannot purchase conventional U.S. government securities.⁴⁵

Similarly, it may be to the benefit of governments in the United States to issue *sukuk* for a third reason: to tap into and reach out to their Muslim citizens. Although most Muslim Americans often ignore the prohibition against *riba* as a practical concession to life in the United States, many do not, and pursue Islamic financing where financing is necessary.⁴⁶ Moreover, the symbolic significance of a *sukuk* issue would not go unappreciated among the growing and embattled Muslim population in this country, particularly if the issuing government units are municipalities where Muslims are particularly concentrated (e.g. Dearborn, Michigan and Paterson, New Jersey or their respective school districts, where the proportion of Muslims is so high that local schools close for Muslim holidays).⁴⁷ In other words, besides the pecuniary interest in expanding the potential market for U.S. federal, state, and municipal securities, the issue of *sukuk* would be a solid indication of a firm commitment to including Muslim citizens in the community.

II. CONSTITUTIONAL LIABILITIES ARISING FROM GOVERNMENT *SUKUK*

However, that very message of inclusion potentially raises a constitutional issue: if government conforms its actions to religious law in a gesture designed to accommodate or include members of a particular religious group, which First Amendment

⁴⁵ The degree to which many of these investors are actually religiously bound is debatable, since some (e.g. Haider Ala Hamoudi of the University of Pittsburgh School of Law) have argued that “Islamic finance” is by and large a sham, mere window-dressing to allow governments in majority-Muslim countries to affirm their “Islamic” credentials while not actually meaning very much in substance. Indeed, this attitude may inform the limit-pushing nature of the *sukuk* system, which often ends up having no practical difference from a secured bond. E-mail from Haider Ala Hamoudi, Assoc. Professor of Law, Univ. of Pittsburgh School of Law, to author (Sept. 26, 2013, 7:39 PM EDT) (on file with author).

⁴⁶ See, e.g., Naureen S. Malik, *Interest-Free Financing for U.S. Muslims*, ABC NEWS, <http://abcnews.go.com/Business/story?id=87070> (last visited Feb. 19, 2014).

⁴⁷ PATERSON PUBLIC SCHOOLS CALENDAR (2014), available at <http://www.paterson.k12.nj.us/calendar/calendar.php?op=cal&month=10&year=2014&catview=0>; DEARBORN PUBLIC SCHOOLS CALENDAR (2014), available at <http://dearbornschools.org/downloads/district-downloads/calendars/1269-2014-2015-calendar-rev-feb-2014/file>. The vacation day on the Dearborn calendar on 3 October 2014, corresponds to Eid al-Adha 1435 AH.

rights are implicated? Does it impermissibly favor or endorse that group (here, Muslims) by conforming its actions to religious law, thus running afoul of the Establishment Clause? Or would a government issue of *sukuk* merely remove a barrier on that group's participation in a proud tradition and critical part of American life—of investing in the community by purchasing government securities—and therefore implicate the Free Exercise Clause?⁴⁸ For that matter, is *either* provision of the First Amendment implicated at all?

A. A Hypothetical

In order to understand what constitutional issues are raised, we must understand what exactly the government in question proposes to do. While there are several different *sukuk* structures, the most common form for sovereign *sukuk* is, as noted above, an *ijarah* based on government-held land. On this basis, we can construct a hypothetical government *sukuk* issue around which we can direct our inquiry.

Suppose the State of New Jersey, for all the good reasons outlined above, were to issue *sukuk* in the standard *ijarah* structure. It must first identify an underlying property. Since roads are a common underlying property for sovereign *ijarah* (New Jersey happens to have two very valuable roads—the New Jersey Turnpike (Turnpike) and the Garden State Parkway (Parkway)—that would serve quite well as an underlying asset), the choice of underlying asset for New Jersey is obvious: we should choose the Turnpike. Indeed, the Turnpike is a consistent money-earner, taking in nearly one billion dollars in tolls annually;⁴⁹ it may be, from the stricter Islamic points of view, a profitable venture most suited to use as backing for *sukuk*. The Legislature would then establish a special-purpose corporation or other vehicle to issue

⁴⁸ Shams Billah, *supra* note 11, raises similar issues respecting the regulation aspect of Islamic finance. The constitutional issues there are substantially starker than they are with government issue of *sukuk*: on one hand, there is the aforementioned *Presbyterian Church* issue regarding adjudications that turn on religious law, but on the other hand the lack of regulation, and therefore of recourse to the courts when these deals go bad, arguably presents a stronger Free Exercise issue than the simple non-issue of acceptable government bonds. This issue is peculiar, dealing as it does with elective decisions to accommodate minorities, and possible implications may be addressed incidentally.

⁴⁹ Anthony G. Attrino, *Report: N.J. Turnpike 'Most Profitable' Toll Road in Nation*, NJ.COM, (July 24, 2013, 6:12 PM) http://www.nj.com/middlesex/index.ssf/2013/07/report_nj_turnpike_most_profitable_toll_road_in_nation.html.

certificates—the *sukuk*—representing an undivided ownership interest in the Turnpike, as well as rights for distribution of the proceeds. Using the money raised by sale of the *sukuk* certificates, the vehicle would then purchase beneficial title in the Turnpike from the State, which would still hold legal title to the roads in trust for the SPV.⁵⁰ The SPV would then lease the Turnpike back to the State, with the total amount of the lease being equal to the purchase price—i.e. the principal of the loan—plus an amount equal to the interest rate on the New Jersey Turnpike Authority’s (Turnpike Authority) conventional bonds. Thus, when the certificates mature, New Jersey will buy back equitable title to the Turnpike and the purchasers of the certificates will realize a return on their investment.

B. The Law

With a model of the factual circumstances, as they would probably occur firmly in place, we can now turn to the question of constitutionality. The foundational case in the Supreme Court’s contemporary Establishment Clause jurisprudence is *Lemon v. Kurtzman*.⁵¹ In *Lemon*, taxpayers in Rhode Island and Pennsylvania challenged statutes in their respective states that provided state funds to religious schools⁵² to help them teach non-religious subjects: Rhode Island, by providing supplemental payments to teachers of secular subjects; and Pennsylvania, by providing direct aid to nonpublic schools for teaching certain secular subjects in accordance with state standards.⁵³ The case implicated several dimensions of the First Amendment protection of freedom of religion,⁵⁴ and finding its previous Establishment Clause jurisprudence “opaque,” it saw fit to synthesize and clarify that jurisprudence before invalidating the Pennsylvania and Rhode Island statutes.⁵⁵ *Lemon* therefore, articulates a three-prong test to determine whether a government interaction with

⁵⁰ As noted, this is the Malaysian model, with the convenience of selling only beneficial title being used to avoid the problems with an absolute sale of the roads—not least of which would be recording the change of title in twelve of New Jersey’s twenty-one counties, and then changing it back upon maturity.

⁵¹ *Lemon v. Kurtzman*, 403 U.S. 602 (1971).

⁵² These statutes also provided funds to non-religious private schools, but these were not the subjects of the case, and—perhaps more to the point—the overwhelming majority of schools receiving these funds were parochial schools, primarily ones belonging to the Roman Catholic Church. *Id.* at 608, 610.

⁵³ *Id.* at 607–10.

⁵⁴ *Id.* at 606, 609, 611.

⁵⁵ *Id.* at 612–13.

religion or religious institutions constitutes an act “establishing” religion:⁵⁶

1. The government’s act must have a “secular purpose.”
2. The act must not “advance or prohibit” any religion, or all of them.
3. The act must not cause or encourage “excessive government entanglement” with religion.⁵⁷

If the state’s act has a non-secular purpose, or advances, prohibits, or entangles government with religion, it is, under *Lemon*, an establishment of religion and therefore unconstitutional. The question, then: were New Jersey to issue *sukuk* as outlined above, would that violate any of these three prongs?

To answer that, allow us to first observe that our hypothetical New Jersey *sukuk* issue is not, in itself, directly governed by religious law. It is constructed from fairly standard units, and governed by secular common-law principles of trust, agency, property, contract, and corporate law. The special-purpose vehicle establishes a trust of which the state is the trustee and the SPV is the beneficiary. The SPV is trustee and agent of the people who buy the undivided shares of title, and is to be responsible as trustee for disbursing the rental payments from the state to the *sukuk* holders.⁵⁸ If the SPV is a corporation, the existing corporate law of New Jersey will govern its affairs. And finally, New Jersey’s laws respecting leases will govern the contract of lease between the SPV and the state. In other words, nothing about its structure is specifically Islamic or governed by Islamic law. It is simply a somewhat more roundabout means of achieving the same ends as issuing a state bond secured by the Turnpike.

If the legal character of the transactions constituting the issue of *sukuk* by the state is entirely conventional, and the transactions are thus entirely governed by existing secular law, then any constitutional liabilities arising from the issue cannot arise from the transactions themselves. Were the exact same transactions made without reference to an attempt to issue Sharia-compliant financial instruments, they would merely be an unusual way of obtaining financing for the Turnpike Authority. In short, the legal instruments are structured so as to make no

⁵⁶ *Lemon*, 403 U.S. at 612–13

⁵⁷ *Id.*

⁵⁸ The means by which it does so also implicate another area of secular law, federal income tax, which will be addressed later in this Note.

explicit reference to religion and thus, have no inherent religious content. Therefore, any constitutional issues arising from such a *sukuk* sale must rest upon either the state's *intent* in entering into this highly unusual financial arrangement, or the *perceptions* generated by the state's participation in a religiously based financial market.

Applying this insight to the *Lemon* test, we find that (1) the first prong—secular purpose—is directly tied to New Jersey's intent in issuing the *sukuk*; (2) the second prong—advancement or prohibition—is tied directly to perceptions of that intent; and (3) the third prong—entanglement—arises out of the interaction between the two. We will address each issue in turn.

1. Secular Purpose; and Dinner at Drumthwacket

Our New Jersey *sukuk* issue is immediately faced with a problem respecting the first prong, as the meaning of “secular purpose” is colored to no small degree by the lens through which we choose to see the act. *Lemon* itself does not provide much guidance on the matter, as the statutes in question in that case clearly met the standard,⁵⁹ so we must turn to other law.

In *Lynch v. Donnelly*,⁶⁰ the Court noted that in previous cases, it had only invalidated government acts “motivated wholly by religious considerations.”⁶¹ In *Lynch*, the Court determined that the inclusion of a nativity scene in a municipality's Christmas display was not an unconstitutional establishment, as it was intended simply to recognize the origins of Christmas, rather than preach the Christian religion, and therefore did not have a “wholly” religious purpose.⁶² “Wholly religious purpose” may seem to be a fairly straightforward concept, but it quickly becomes apparent that it is no help in our circumstances. Grunstein argues, relying on this language in *Lynch*, that federal regulation of Islamic financial markets would necessarily have a “religious purpose” because the only reason to enter into a Sharia-compliant financial transaction (e.g. issuing *sukuk*) is to follow the moral and religious commands of Islam.⁶³ The general tendency for debt-based, interest-bearing financial instruments to carry lower risk and higher returns for means “[t]here is no genuine reason”, Grunstein writes, “for anyone to use...Shari'ah-compliant

⁵⁹ *Lemon*, 403 U.S. at 613.

⁶⁰ *Lynch v. Donnelly*, 465 U.S. 668 (1984).

⁶¹ *Id.* at 680.

⁶² *Id.* at 680–81.

⁶³ Grunstein, *supra* note 7, at 746–47.

vehicles...other than to fulfill a religious obligation.”⁶⁴ If Grunstein is correct, it follows, that government regulation of the market for Sharia-compliant securities like *sukuk*—and, it would seem, the issue of such securities as well—would be unconstitutional.⁶⁵

To some degree this is persuasive; it is true that were it not for a religious command, the state would not seek to conform a financial transaction to religious law. However, there is also something clearly askew here: the point Grunstein is making seems not to make much intuitive sense. To clarify why that might be, perhaps we should bring ourselves out of the rather abstract world of finance and into the more concrete world of food.

Suppose that Governor Chris Christie were to host, among other guests, a delegation of kosher-keeping Israeli businessmen at a formal state dinner at Drumthwacket, where he expects to discuss their technology company’s plans to set up a branch in New Brunswick.⁶⁶ In order to avoid unnecessarily offending his guests, the Governor would be wise to ask the kitchen to send someone to the nearest kosher butcher to procure the meat, if any, that might be required for the meal and perhaps (if the businessmen are particularly wary) to bring in a rabbi to supervise the kitchen as an assurance of compliance with Kashrut. Since this is a formal state dinner, held to advance government policy and on State property⁶⁷ Christie would clearly be entertaining the Israelis in his formal capacity as Governor of New Jersey. Supposing that the kitchen staff at Drumthwacket are employees of the State of New Jersey and that any kosher meat used in the meal and any fee the rabbi might ask for supervising the kitchen would be paid for with funds from the New Jersey state treasury (which is not unlikely)⁶⁸ it is hard to characterize this meal as

⁶⁴ *Id.* at 747.

⁶⁵ See Grunstein, *supra* note 7, at 747 (“There is also no plausible secular purpose for codifying under U.S. law these religious oriented financial structures.”).

⁶⁶ Drumthwacket is New Jersey’s official Governor’s residence, in Princeton, N.J. Governor Christie does not reside there but does use the residence for state functions and Sunday dinners. *Christie: I Won’t Live at Drumthwacket*, THE TRENTONIAN (Nov. 7, 2009, 12:01 AM) [http://www.trentonian.com/article/20091107/NEWS/311079983/christie-i-won-t-live-at-drumthwacket?mobredirect](http://www.trentonian.com/article/20091107/NEWS/311079983/christie-i-won-t-live-at-drumthwacket?mobredirect=true)

=true.

⁶⁷ Drumthwacket is owned by the State of New Jersey. See NAT’L PARK SERV., *Drumthwacket*, in NAT’L REGISTER OF HISTORIC PLACES, available at <http://pdfhost.focus.nps.gov/docs/nrhp/text/75001142.PDF>.

⁶⁸ There is a private foundation for the preservation of Drumthwacket, but it does not fund the mansion’s kitchen. *Mission*, THE DRUMTHWACKET

anything other than state action. Under Grunstein's framework, this whole business of trying to accommodate these observant Jewish Israelis would have a religious purpose: after all, were it not for the observant Jewish guests, no kosher meat would be bought (or, if no meat was bought at all and the meal was vegetarian, meat would not have been specifically avoided), nor any rabbi paid to supervise. Since providing a non-kosher meal would have provided the same or greater value (depending on how much one likes pork, shellfish, or ice cream after a steak dinner) at a lower cost, there is, in Grunstein's framework, "no genuine reason" to serve the kosher meal other than to fulfill someone's religious obligation.

Intuitively, this makes no sense: if true, then any attempt to accommodate the religiously-based dietary needs of believers—including citizens—at state functions where food is served would be unconstitutional. Such an interpretation may even render unconstitutional serving kosher or halal food at state university dining halls—and perhaps more to the point, imagine if the Governor were himself Jewish and observant! Clearly, reading the "secular purpose" test to mean that any state action with no explanation except for fulfilling someone's religious obligation is untenable. Rather, we must understand the purpose to mean the *actual* purpose of the state in acting as it did—in the case of the Governor's dinner, providing these important guests with a meal they could eat, and hopefully cementing their plans to open in New Brunswick. By the same token, we cannot understand the primary purpose of our New Jersey *sukuk* issue as being religious: rather, the state's purpose is to increase the number of potential purchasers of its government securities by offering observant Muslims with money with a financial product they could buy.

The courts have clearly recognized this, and the jurisprudence on the "secular purpose" prong of the *Lemon* test has consistently focused on the actual intent of the government,⁶⁹ and whether the intent of challenged state action was *promoting* religion, rather than whether it was to *accommodate* it. For instance, in *Wallace v. Jaffree*,⁷⁰ a father challenged, on behalf of his minor school children, several Alabama statutes authorizing a one-minute moment of silence for "meditation or voluntary

FOUNDATION, <http://www.drumthwacket.org/about/mission> (last visited Mar. 11, 2015).

⁶⁹ See, e.g., *Edwards v. Aguillard*, 482 U.S. 578, 585 (1987) ("The purpose prong of the *Lemon* test asks whether government's actual purpose is to endorse or disapprove of religion.") (internal quotations omitted).

⁷⁰ *Wallace v. Jaffree*, 472 U.S. 38 (1985).

prayer.”⁷¹ The Court, in deciding the case, turned to the legislative history of the statute, and noted that the state senator who had introduced the statute in question “did not have no [sic] other purpose in mind” other than the return of prayer to Alabama’s schools,⁷² and therefore had no secular purpose whatsoever.⁷³ By way of distinction, the Court held that even if government action is “partially motivated” by religion, it may still pass the “secular purpose” prong of the *Lemon* test if the state articulates another, secular objective.⁷⁴

Of course, this raises the temptation for states to clothe religiously motivated policy with a secular purpose. Consider *Edwards v. Aguillard*, in which the State of Louisiana attempted to justify its requirement that its public schools teach “creation science” if they wish to teach the Darwinian theory of evolution for the origin of life on the grounds that it was promoting the secular goal of “academic freedom.”⁷⁵ Examining the legislative history of the statute, the Court noted that it was apparent the statute did little to further the goal of “academic freedom,”⁷⁶ and could only reasonably be explained by a desire to advance a religious worldview.⁷⁷ Noting that where a “sham” secular purpose is articulated for government action, it will be given less deference, the Court struck the Louisiana statute down.⁷⁸

For our New Jersey *sukuk* issue, this test presents few problems. In contrast to the 1980s line of cases from which this standard arises, in which state legislators were attempting to bring back a previously invalidated religious or religion-based practice through a back door,⁷⁹ we are here adapting an entirely

⁷¹ *Id.* at 40–41.

⁷² *Id.* at 56–57.

⁷³ *Id.* at 59–60.

⁷⁴ *Id.* at 57.

⁷⁵ *Edwards*, 482 U.S. at 586.

⁷⁶ *Id.* (“Even if ‘academic freedom’ is read to mean ‘teaching all of the evidence’ with respect to the origin of human being . . . the goal of a more comprehensive science curriculum is not furthered by either outlawing the teaching of evolution or requiring the teaching of creation science.”).

⁷⁷ *Id.* at 588–89. (“We agree . . . that the Act does not protect academic freedom, but has the distinctly different purpose of discrediting ‘evolution by counterbalancing its teaching at every turn with the teaching of creationism.’”) (citations omitted) (quoting *Aguillard v. Edwards*, 765 F.2d 1251, 1257 (5th Cir. 1985)).

⁷⁸ *Edwards*, 482 U.S. at 586–87.

⁷⁹ Again, these most prominently were school prayer, disguised as a moment of silence, as in *Wallace*, and creationism, disguised as teaching “creation science” with an aim of “promoting academic freedom,” in *Edwards*—in short, several of the hot-button issues of the then-current “culture wars” that had been invalidated by prior decisions. See generally *Wallace*, 472 U.S. 38, and *Edwards*,

secular practice to religious needs. The state needs money and is a good credit risk; Muslims have money and are looking for a safe place to put it, if it complies with their religious law. Whether the intended market is New Jersey's Muslims (in an attempt to give them a stake in their state),⁸⁰ or the wealthy Muslims and Islamic financial institutions of the Middle East and Southeast Asia (in an attempt to raise as much capital as possible), the state is primarily making an essentially economic and financial decision, attempting to obtain more credit and expand its creditor base.⁸¹ Structuring the transaction to comply with Islamic law is simply the means by which it does so. In other words, although it is true that but for Islam, New Jersey would never issue *sukuk*, its purpose in doing so is perhaps the single most secular purpose of all—money.

2. Endorsement

With money as the actual purpose of the state's conformation of its action to religious principle, we can reasonably presume that a court would not find a New Jersey *sukuk* issue unconstitutional on the grounds that it has no secular purpose. We therefore, turn to the next *Lemon* prong—whether the state issue of *sukuk* would somehow be seen as encouraging or endorsing religion.

It does not intuitively seem so. However, the possibility merits further investigation. For his part, Grunstein argues that government *regulation* of the Islamic financial market would, in effect, incorporate Islamic law into the body of American securities

482 U.S. 578, 585; see generally Douglas Laycock, *Substantive Neutrality Revisited*, 110 W. VA. L. REV. 51 (2007) (placing *Wallace, Edwards*, and other Establishment Clause cases in the context of the 1970s-2000s "culture wars"). To the extent that the place of Muslims in contemporary American society causes similar controversy today, one may make of the prospect of U.S. sovereign *sukuk* what one will.

⁸⁰ A principle that may be more justified in the case of a municipality or school district rather than the state as a whole; one imagines it is more important to the Paterson Public Schools to give the very large proportion of Muslim parents it serves a financial stake in its future than it is for the State of New Jersey to give its relatively small proportion of Muslim citizens an opportunity to buy its bonds.

⁸¹ Again, the state may have financial reasons for attempting or not attempting to expand its creditor base. New Jersey may not have any particular need or desire to reach out to new potential creditors; the Turnpike's very profitability under its current operating arrangement, in which tolls are used to pay back conventional loans, may make a *sukuk* issue an unattractive option from a financial perspective, given that the status quo appears satisfactory. See Attrino, *supra* note 49. However, we are not concerned with the wisdom of adopting this unconventional financing scheme, but rather its legal consequences.

law, making Islam the “law of the land” and therefore unconstitutionally endorsing a religion.⁸² However, Grunstein makes no mention of government *issuing* Islamic securities; are they vulnerable to the same critique?

It is not impossible to imagine a circumstance in which they are. However, for our purposes, the *sukuk* issue is structured by reference to the secular common and statutory law of New Jersey. Even if they made more explicit reference to Islamic law, the *sukuk* issued are not law, but rather a transaction to which the government is a party. The government here acts as a legal subject, rather than as a maker of law; the contents of government contracts are no more the law of the land than any other contract. It would be hard to characterize a state *sukuk* issue as somehow incorporating Islamic law into the law of New Jersey, so on this level, it does not appear to violate the endorsement test.⁸³

Despite this, it does seem that there may be a concern that by participating in a market whose existence is based in Islamic law, the state may be subtly sending a message of approval respecting Islam. Although the purpose of our New Jersey *sukuk* issue is to accommodate Muslims, even a good-faith attempt to accommodate members of a minority faith may effectively constitute an impermissible endorsement of religion. Arguably, one of the most similar Supreme Court cases to our hypothetical is *Lee v. Weisman*,⁸⁴ in which a Rhode Island school district chose a rabbi to conduct a “nonsectarian” invocation benediction at a graduation ceremony.⁸⁵ The invocation and benediction made no reference to any particular religious doctrine, although it did direct itself towards God,⁸⁶ and presumably the choice of a rabbi rather than a Christian priest or minister was a gesture of inclusiveness to Jewish students. Yet the Court affirmed the District of Rhode Island’s grant of a permanent injunction against

⁸² Grunstein, *supra* note 7, at 748.

⁸³ It is true that issues of Islamic law might arise in cases where the *sukuk* are the subject of a lawsuit. For instance, one can imagine circumstances where a Muslim purchases New Jersey *sukuk*, and only later consults with a cleric, who decides that under his interpretation of Islamic law, the *sukuk* are impermissible. This is entirely possible, as clerics are not in universal agreement about what kinds of arrangements are permissible. See Grunstein, *supra* note 7, at 750. Were the Muslim buyer to then sue the state for misrepresentation on the grounds that the alleged *sukuk* were in fact forbidden, the decision could turn on a point of Islamic law. This is problematic, but more closely allied to the issue of government entanglement with religion, rather than endorsement of it, and will be addressed at a later stage.

⁸⁴ *Lee v. Weisman*, 505 U.S. 577 (1992).

⁸⁵ *Id.* at 581.

⁸⁶ *Id.* at 581-82.

similar invocations or benedictions in future ceremonies; even the minimal religious content in the invocation was sufficient to show the rabbi was acting religiously, and thus constituted an endorsement of religion.⁸⁷ In so doing, it stated that an accommodation of religion may go too far and become an establishment.⁸⁸ Our *sukuk* issue is clearly an accommodation; the question, then, is, whether one that encourages religion.

It is difficult to see how this might be, however. In cases, like *Lee*, where the Supreme Court has found a government act to accommodate a religion and impermissibly endorse that religion, the government has done at least three things. First, it made some kind of highly public display with explicit religious content; second, it did so in reference to the socially dominant Christianity or “Judeo-Christianity,” rather than a small and often embattled religious minority; and third, it did not clearly have some material or other non-religious motive that would disabuse the public of any notions it might have that it is trying to support religion.⁸⁹ With respect to our *sukuk* issue, none of these circumstances apply. In the first place, a state bond issue is rarely something that makes the headlines. Admittedly, a New Jersey issue of *sukuk* is not your ordinary bond issue, and might cause some stir in the press: Britain’s plan to issue *sukuk* was widely reported in mainstream media,⁹⁰ and led to a not inconsiderable amount of agitation in the gutter press and among British cultural conservatives about

⁸⁷ *Id.* at 599. The invocation opened, “God of the Free and Hope of the Brave,” the benediction stated “O God, we are grateful to you,” and “we give thanks to you, Lord,” and both invocation and benediction closed with an “Amen.” *Id.* at 581-82.

⁸⁸ *Id.* at 586-87.

⁸⁹ See also *Cnty. of Allegheny v. Am. Civil Liberties Union Greater Pittsburgh Chapter*, 492 U.S. 573, 598-602 (1989) (abrogated on other grounds by *Town of Greece v. Galloway*, 134 S. Ct. 1811 (2014)) (nativity crèche containing certain explicitly religious messages and clearly noted as property of a Roman Catholic organization displayed prominently at county courthouse unconstitutionally endorses Christianity); *McCreary Cnty., Ky. v. Am. Civil Liberties Union of Ky.*, 545 U.S. 844, 866, 868-70 (2005) (display of the Ten Commandments at a county courthouse could be unconstitutional endorsement of Biblical religions dependent on the history of the display). See also *Town of Greece*, 134 S. Ct. at 1824 (town’s reasonable attempts at including non-Christian ministers in prayer before town council meetings indicated that it was not attempting to endorse religion).

⁹⁰ See, e.g., *Cameron Unveils Islamic Bond Plan*, BBC NEWS (Oct. 29, 2013, 12:14 PM) <http://www.bbc.co.uk/news/business-24722440>; Harry Wilson, *Britain to Become First Non-Muslim Country to Launch Sharia Bond*, THE TELEGRAPH (Oct. 29, 2013, 12:01 AM) <http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/10410467/Britain-to-become-first-non-Muslim-country-to-launch-sharia-bond.html>.

Muslim influence in Britain,⁹¹ and there is very little reason to believe the American press will react any less calmly. In that sense, perhaps, there is a risk that non-Muslims would perceive the *sukuk* issue as a “disapproval...of their religious choices.”⁹² But even though a New Jersey *sukuk* issue would probably be more publicized than a typical conventional bond issue, the fact remains that the *sukuk* themselves, if structured as proposed in our hypothetical, have no more religious content than a peanut butter sandwich: they are simply common-law contracts (of trust, of agency, of lease, of sale, etc.) that happen to conform to the strictures of Islamic law. Much like the sandwich, the *sukuk* could be sold either to an observant Muslim or to a non-Muslim and neither should have any moral problem with it.⁹³

And of course, it is critical here to recognize that even if some non-Muslims understood a *sukuk* issue by the state of New Jersey to be an endorsement of Islam, objectively Islam is a very peculiar thing for New Jersey to be endorsing. Only a small percentage of New Jersey citizens are Muslim.⁹⁴ Meanwhile, as shown above, all instances of religious “accommodation” that have been found impermissible by the Supreme Court to date have been accommodations based on Christianity or a “nonsectarian” “Judeo-Christian” tradition. The message intended to be sent, if any, by a New Jersey *sukuk* offering would be “Muslims can be New Jerseyans and do anything other New Jerseyans do,” rather than, “Islam is somehow superior, so we will adopt this bond

⁹¹ See, e.g., Matt Chorley, *Cameron Launches Bid to Attract More Arab Money to Britain as he Defends Foreign Takeovers of our Football Clubs*, THE DAILY MAIL (Oct. 29, 2013, 1:51 PM) <http://www.dailymail.co.uk/news/article-2478727/Cameron-launches-bid-attract->; Edward Malnick and John Bingham, *Bishop Fears Sharia Bonds Pave Way for more Islamic Law*, THE TELEGRAPH (Nov. 2, 2013, 9:00 PM), <http://www.telegraph.co.uk/news/religion/10423016/Bishop-fears-sharia-bonds-pave-way-for-more-Islamic-law.html>.

⁹² *Cnty. of Allegheny*, 492 U.S. at 597 (quoting *Sch. Dist. of Grand Rapids v. Ball*, 473 U.S. 373, 389 (1985) (overruled on other grounds by *Agostini v. Felton*, 521 U.S. 203 (1997))).

⁹³ Perhaps we could say the peanut butter sandwich has religious content if it was made for the Muslim because the only alternative was a ham sandwich; however, that argument is equivalent to Grunstein’s argument about “secular purpose,” bringing us back to Christie’s Drumthwacket dinner.

⁹⁴ Estimates are consistently in the single digits. A 2010 study estimates the total number of Muslim “adherents”—i.e. affiliated with a congregation—in New Jersey to be 160,666, or just about 1.2% of New Jersey’s population of 8.9 million. *State Membership Report: New Jersey 2010*, ASSOCIATION OF RELIGION DATA ARCHIVES, http://www.thearda.com/rcms2010/r/s/34/rcms2010_34_state_adh_2010.asp (last visited Feb. 20, 2014).

structure.”⁹⁵ Perhaps more to the point, the only way in which one could realistically perceive any religious message from a state’s decision to issue *sukuk* would be if it coupled that decision with another decision to cease issuing conventional bonds. In the right circumstances, such a decision may be read to mean that Islam’s moral judgment respecting *riba*/interest is correct, and that therefore, Islamic securities are moral and conventional ones immoral. However, New Jersey, in our hypothetical, need not cease issuing conventional bonds; indeed, our hypothetical contemplates that it will continue to rely on conventional securities for the bulk of its financing needs. The *sukuk* would merely supplement the financing obtained in the conventional market, diversifying the state’s creditor base and perhaps sending a message of inclusion to the state’s Muslim minority.⁹⁶

But even if the state were to cease issuing conventional bonds, we could not automatically understand that the state was agreeing with Islam’s moral judgment about how to structure debt. We cannot forget here that at the end of the day, we are talking about money, and if these *sukuk* were to prove a better way for the

⁹⁵ In a polity in which Muslims form a majority of inhabitants, one supposes that a decision to begin issuing sovereign *sukuk* made while a party that makes a show of its piety and Islamic identity is in power might legitimately be seen as a kind of veiled threat to any non-Muslim minority. However, that is not the case here.

⁹⁶ Some might argue that this decision to accommodate Muslims in the bond market is implicitly a decision not to accommodate the requirements of other religions in the way the state operates, and therefore discriminatory against non-Muslims, essentially saying, “Of the various minority religions, Islam is the best.” It is possible that some might read it that way, but one has to remember that not all accommodations are created equal; there may be non-religious factors militating against implementing some accommodations and in favor of implementing others. For instance, it would be technically possible to install Sabbath elevators (ones that stop on every floor) and timed lights in public housing in order to accommodate any observant Jews who live there and keep the Sabbath commandments, but this is not generally done. We could imagine someone saying that accommodating Muslims in the bond market but not accommodating Jews in public housing favors Muslims over Jews. However, this argument ignores the cost to the state of installing Sabbath accommodations, and, in the case of the Sabbath elevator, the possibility it might also inconvenience non-Jews who live in the building. On the other hand, a *sukuk* issue is a moneymaking venture for the state, with little cost other than potential legal liabilities like the ones addressed in this note, and has little impact on non-Muslims’ ability to purchase the conventional government bonds that will continue to be issued regardless. People observing the situation are more likely to understand the state’s grant of the latter accommodation and denial of the former one as reflecting cost, rather than reflecting favoritism. In other words, the choice to make one accommodation and not another cannot be generally understood to be an endorsement or preference for one religion over another.

state to obtain funds—if they had a lower interest rate, perhaps, or if they exposed the state to lower liability than their conventional equivalents—there would be no endorsement of religion in using them more generally. And that leads us to a critical point: the very fact that this entire business is about getting financing for the state should disabuse anyone—or at least anyone rational—of the notion that New Jersey would, by issuing *sukuk*, somehow be saying Islam is better than other religions. If anything, the message New Jersey sends in issuing *sukuk* would be, “New Jersey to Muslims: You have money. We need money. Let’s make a deal.” The only god New Jersey endorses by issuing *sukuk* is the Almighty Dollar.

3. Entanglement

Having found that the purpose of issuing *sukuk* is money, and that the *sukuk* issuance would be nothing more than an endorsement of money, the fact remains that *sukuk* are structured to comply with Islamic law. This brings forward another critique—and a fairly common one—of attempting to regulate Islamic transactions: that it would require American courts to interpret Islamic law. Unlike other critiques of regulating Islamic finance, this one does have some application to state-issued *sukuk*. Like any other financial or legal instrument, the *sukuk* run the risk that someone will bring suit over them. This may be particularly true of the *sukuk*, as they are a relatively novel form of financing in the United States, and will therefore raise more and more fundamental legal issues than conventional bonds. The question, then, is whether the issues in cases arising from *sukuk* will turn on points of Islamic law, or whether the courts will be able to resolve them exclusively on secular grounds.

On the face of it, the conventional structure of the New Jersey *sukuk* transactions would seem to be a barrier to the appearance of cases turning on Islamic law. If the leases, trusts, and other contracts underlying the *sukuk* are entirely conventional, it stands to reason that issues of Islamic law will not arise in adjudicating disputes concerning them.

On the other hand, there are circumstances in which a court might be forced to interpret Islamic law. The most obvious is a case where a Muslim purchases the *sukuk*, and then discovers that something in them makes them impermissible under his preferred interpretation of Islam, and sues the state under a theory of misrepresentation. In theory, at least, adjudication of this case would require the court to determine whether or not the

sukuk were Islamic. The parallels to the main Supreme Court case on the subject, *Presbyterian Church*, are clear: in *Presbyterian Church*, a local congregation in Georgia sought to block the central Presbyterian Church organization from taking their houses of worship, after the congregation voted to secede from the Church on the grounds that under Georgia law,⁹⁷ a church's entitlement to property was held in trust so long as it followed its doctrines. The Church, the congregation argued, was no longer truly following Presbyterian doctrine, and therefore not entitled to take the congregation's property. The Church countered that there was a genuine dispute between the general Church and the congregation about what Presbyterian doctrine is, and therefore the secular courts have no business interfering.⁹⁸ The Supreme Court agreed with the general Church, finding it most awkward to decide a case that depended on "what does it mean to be a Presbyterian?"⁹⁹ In our hypothetical securities fraud action (e.g. under Rule 10b-5),¹⁰⁰ the plaintiffs would claim, in essence, that the State of New Jersey had made a material misstatement in representing the *sukuk* to be acceptable to them, when their cleric had said they were not, and the state would argue that its experts had assured them that the *sukuk* were just fine and no misstatement was made. The court could then be in the extremely awkward position of having to decide between the opinions of two clerics on the meaning of Islamic doctrine.

However, what if New Jersey were not to claim that the *sukuk* were entirely permissible, but rather state that they follow certain standards, which the major Islamic financial authorities agree are acceptable but which some other authorities on Islamic law may consider unacceptable?¹⁰¹ It would appear that in such circumstances, the action for fraud would fail. So long as the state made it clear that the *sukuk* conform to one particular understanding of Islamic law but may not conform to others, there

⁹⁷ *Presbyterian Church*, 339 U.S. at 442–43.

⁹⁸ *Id.* at 443.

⁹⁹ *Id.* at 450–51. The points at issue were foundational indeed, as they arose out of the great religious debates of the age, including the ordination of women, social and economic justice, the end of school prayer, the Church's ecumenical orientation, and other elements of religious doctrine. *Id.* at 442, n.1.

¹⁰⁰ SEC Exchange Act Rules, Employment of Manipulative and Deceptive Devices, 17 C.F.R. § 240.10b-5 (authorizing private rights of action for material misrepresentation or omission or engage in other activity that might "operate as a fraud or deceit upon a person" in connection with the sale of a security).

¹⁰¹ To put additional strain on our kosher-food analogy, this is the equivalent of the state purchasing meat certified kosher by a particular rabbi, only claiming the meat has been certified by that rabbi, and cautioning that other rabbis may not agree with him.

would be no misrepresentation and thus there could be no fraud claim.

Of course, one might argue that the very act of consulting with clerics—which New Jersey might be well advised to do if it were to make a *sukuk* issue—would be an unconstitutional entanglement. After all, in such a case, the state would be requesting that a religious official give advice on how to proceed with its actions. However, the absurdity of calling *consultation* an entanglement becomes apparent on review of the Supreme Court’s precedent in *Gonzalez v. Roman Catholic Archbishop of Manila*.¹⁰² In *Gonzalez*, a man in the Philippines, then an American colony, tried to force the Archdiocese to grant him a particular collatory chaplaincy that he claimed had been left to him in a will.¹⁰³ The Archdiocese claimed that as a matter of canon law, the plaintiff was not entitled to a chaplaincy.¹⁰⁴ The Supreme Court ruled in favor of the Archdiocese, and denied the petitioner the chaplaincy, on the grounds that the civil courts would not challenge the Archdiocese’s decision respecting Catholic canon law.¹⁰⁵ Later, in *Presbyterian Church* itself, the Court reaffirmed the validity of this reliance, distinguishing the reliance on a single cleric’s opinion—whose opinion was authoritative—from the creation of a state standard regarding “departure from doctrine” that two sincerely committed and learned believers might legitimately dispute.¹⁰⁶ In the case of the *sukuk* issue, no cleric’s determination of Islamic law is authoritative. Islam has no hierarchy that could clearly and finally decide the law in the same way the Catholic Church can. However, since the only real issue likely to arise out of *sukuk* structured in the manner presented here would come out of the aforementioned kind of misrepresentation/quasi-fraud action, this lack of finality is a nonissue so long as the state is clear which clerics’ rulings it has conformed the *sukuk* to.

III. OTHER LIABILITIES AND ISSUES ARISING FROM STATE *SUKUK* ISSUE

Having concluded that state and municipal *sukuk* are, in all likelihood, constitutional (so long as they are issued in a form largely composed of ordinary-law contracts, and will not require unconstitutional action by the courts, so long as the state is clear

¹⁰² *Gonzalez v. Roman Catholic Archbishop of Manila*, 280 U.S. 1 (1929).

¹⁰³ *Id.* at 11.

¹⁰⁴ *Id.* at 12–13.

¹⁰⁵ *Id.* at 17–18.

¹⁰⁶ *Presbyterian Church*, 339 U.S. at 450–51.

regarding what it is selling), we can now turn to non-constitutional areas of concern arising from the state issue of *sukuk*. These concerns can be broadly divided into three classes: commercial concerns, Islamic concerns, and political/social concerns. Of these, political and social concerns are probably the most important in practical terms, since in all likelihood it is politics that would constitute the major reason not to issue *sukuk* for any given state. However, beyond that there is not much to say; certainly, it does not lend itself to any kind of legal analysis.

Also, not lending themselves well to analysis are the Islamic concerns raised by our hypothetical New Jersey *sukuk* structure. To be sure, this inquiry would be quite interesting, but it would also be extraordinarily complex. Although we have Islamic law to guide a legal-type analysis here, that law is so diffuse and so pluricentric that an adequate discussion of these concerns would require a paper of its own.

Therefore, I focus here primarily on the commercial concerns raised by our hypothetical *sukuk* structure, with occasional reference to the other concerns. By “commercial concerns,” I refer primarily to the practical business calculations associated with entering a new and more or less untested securities market. Since the *sukuk* structure is somewhat novel, particularly in the United States, it brings with it an element of risk not present in equivalent secured government bonds. The precise nature of the liabilities in *sukuk* has not been laid out in case after case and statute after statute, in the same way that the liabilities associated with bonds have. This is no small matter: before the state will issue *sukuk*, they want to be sure that people will actually buy them, and people who might be interested in these *sukuk* will want to know what exactly they are getting into. To that end, we investigate.

A. Tax Issues

One concern that Americans in the market for our hypothetical New Jersey *sukuk* may have is, on its face at least, a rather straightforward one: will income from these *sukuk* be exempt from federal income tax? Under Section 103 of the Internal Revenue Code, the interest from U.S. state and municipal bonds is not included in gross income for the purposes of federal income tax.¹⁰⁷ This allows qualified government entities—including states and municipalities—to obtain lower interest rates on their bonds,

¹⁰⁷ I.R.C. § 103(a) (2012).

as bondholders realize the same after-tax income from a government bond as from a corporate or other non-government bond with a substantially higher pre-tax rate of return. In theory at least, this is good both for bondholders, as they can take a lower risk for the same after-tax return, and for the government entities issuing the bonds, as it encourages people to buy government bonds, which can at times have problems in attracting buyers.¹⁰⁸

The concern respecting the tax consequences of *sukuk* becomes clear from the language of §103: “Except as provided in subsection (b), gross income does not include interest on any State or local bond.”¹⁰⁹ Therein lies the problem: the Code provides that “interest” from “State or local bonds” is exempt from gross income. *Sukuk* are not, strictly speaking, supposed to be considered bonds, and are structured to *avoid* paying “interest,” since even if *riba* cannot be precisely identified with “interest,” there is little question that “interest” is in general a form of *riba*. *Sukuk* are thus engineered to formally *not* be interest-bearing obligations of the kind contemplated by Section 103, but complex real estate transactions (in our hypothetical, anyway) designed to *replicate* the *effects* of a loan. The annual or other periodic payments to holders of *sukuk* are, in theory at least, the rent the state pays to *sukuk* holders in exchange for use of the underlying asset, and rent is, in general, taxable gross income.¹¹⁰

Therefore, the question of interest to taxpayers—and of the state issuing the *sukuk*, since it wants the public to buy them—is this: will the *sukuk* be recognized for what they are—i.e. secured bonds by another name—and the “rent” recognized as the equivalent of interest (and therefore exempt from tax)? Or will the formal legal structure of the *sukuk* transaction be respected by the courts, and the “rent” recognized as rent (and therefore not exempt from tax)?

¹⁰⁸ Several tax cases make it clear, directly or by implication, that this is the purpose of Section 103. *See, e.g.*, *Drew v. United States*, 551 F.2d 85, 87 (5th Cir. 1977) (“The Supreme Court has made it clear that the purpose of Section 103 is to encourage loans in aid of governmental borrowing power.”); *Fox v. United States*, 397 F.2d 119, 112 (8th Cir. 1968) (“The legislative history clearly indicates that the purpose of the exclusion is to permit state and local governments to obtain capital at a low rate of interest.”); *Holley v. United States*, 124 F.2d 909, 911 (6th Cir. 1942) (“Congress established the exemptions in this section to aid in the flotation of government bonds by making them tax-free, and therefore more attractive to investors.”).

¹⁰⁹ I.R.C. § 103(a).

¹¹⁰ I.R.C. § 61(a)(5) (2012) (“Except as otherwise provided in this title, gross income means all income from whatever source derived, including but not limited to . . . [r]ents.”).

The case law on this point does not directly address our issue.¹¹¹ Most cases interpreting Section 103 have come from instances where there is no question the taxpayer was a creditor of the state holding an instrument or account that bore interest payable by the state to the taxpayer. In two of these cases, for example, the taxpayer received payment for property taken by eminent domain in the form of an interest-bearing obligation from a subunit of the state. In *Holley v. United States*, the City of Detroit took land from the taxpayer in order to expand Woodward Avenue,¹¹² and being somewhat short of cash, agreed with him to pay the constitutionally required just compensation in installments, with the unpaid balance to collect annual interest.¹¹³ In *Drew v. United States*, an agency of the State of Texas compensated the taxpayer for seizure of his land to build Lake Livingston¹¹⁴ by providing him with warrants granting him deferred payment and, again, interest on the unpaid balance.¹¹⁵ In another case, the taxpayers held interest-bearing certificates of deposit with the Bank of North Dakota, which is owned by the State of North Dakota.¹¹⁶ In all these cases, the interest was found not to be exempt from gross income.¹¹⁷ In each case, the Court relied on broadly similar logic: that in order to benefit from Section 103, the interest-bearing obligation the taxpayer holds must have been created in an exercise of the “borrowing power” of the state.¹¹⁸

But what, exactly, *is* the borrowing power of the state? That is what the issuers of *sukuk* and the buyers would really want to know. The cases do provide some guidance: for instance, the taxpayer’s “loan” to the state (whatever that might be called) must be a voluntary transaction; hence the impermissibility of excluding

¹¹¹ Much of it is also old, generally predating the Tax Reform Act of 1986. However, the Tax Reform Act seems not to have had much of an impact on the jurisprudence.

¹¹² Woodward Avenue is the “Main Street” of Detroit, and Southeast Michigan more generally. *Woodward Avenue: a Road to the Heart and Soul of America*, M.D.O.T. TODAY, 2003, at 8, available at https://www.michigan.gov/documents/MDOT_Woodward_Heart_and_Soul_170072_7.pdf.

¹¹³ *Holley*, 124 F.2d at 910.

¹¹⁴ Lake Livingston is a reservoir supplying water to Houston. *Drew*, 551 F.2d at 86-87.

¹¹⁵ *Id.* at 87.

¹¹⁶ *Fox*, 397 F.2d at 120–21.

¹¹⁷ *Holley*, 124 F.2d at 911; *Fox*, 397 F.2d at 123; *Drew*, 551 F.2d at 89.

¹¹⁸ *Holley*, 124 F.2d at 910–11; *Fox*, 397 F.2d at 122 (quoting Comm’r v. Meyer, 104 F.2d 155, 156 (2d Cir. 1939) (citations omitted)); *Drew*, 551 F.2d at 87. This law is current, and importantly for the purposes of our hypothetical *sukuk* issue in New Jersey, applied by the Third Circuit; see *DeNaples v. Comm’r*, 674 F.3d 172, 176-77 (3d Cir. 2012) (quoting *Drew* to demonstrate the principle).

interest derived from deferred payment for land taken by eminent domain.¹¹⁹ Our *sukuk* clearly meet that test; the *sukuk* holders will have purchased them entirely voluntarily. The money must also be available for “governmental operation” and not be in the form of a deposit.¹²⁰ The *sukuk* also clearly pass this test; for instance, in our New Jersey example, the funds derived from the initial sale of the *sukuk* certificates would be immediately available to the State of New Jersey or to the Turnpike Authority, depending on how the state wants to direct the revenue stream.

This is all well and good, but none of this guidance definitively answers the fundamental question of whether the payments to the *sukuk* holders would or would not be treated as taxable income, nor is there any reason for there to be any guidance on this issue. The cases cited above all centered on instances where the state clearly and openly paid interest but did not issue bonds; they did not address any instance in which the state issued bonds but did not officially pay interest. And why should any case have addressed this issue? Until recently, there really has been no significant reason for states to enter into financial structures that did not technically charge interest, but produced the same effect as issuing interest-bearing securities. It is only now that these novel arrangements would be any kind of concern to any court, let alone a tax court.

Even an appeal to the text and the canons of statutory construction only provide the barest inkling of how a court would treat state-issued *sukuk* for tax purposes. Subsection (c) of Section 103 purports to define “State or local bond,” but it merely states that any “obligation” of a state or political subdivision of a state is a “State or local bond” for the purposes of the section.¹²¹ This merely changes the question to what constitutes an “obligation” of a state or local government. And here we run into a tension within the jurisprudence. On the one hand, it is a basic principle of the construction of tax statutes that tax exemptions are to be construed narrowly; they will not be implied from the statute.¹²² This would seem to bode ill for *sukuk*, since whatever else they are, they are not formally interest-bearing securities; and whatever else Congress may have meant by “bonds” and “obligations,” it almost certainly only meant instruments that bear interest (this being the usual understanding of the terms). On the

¹¹⁹ *Holley*, 124 F.2d at 911; *Drew*, 551 F.2d at 87–88.

¹²⁰ *Fox*, 397 F.2d at 123.

¹²¹ I.R.C. § 103(c)(1) (2012).

¹²² *Mescalero Apache Tribe v. Jones*, 411 U.S. 145, 155 (1973); *see also DiNaples*, 674 F.3d at 176.

other hand, the purpose of the exemption must be taken into account; even the narrow interpretation of the exemption cannot be “so literal and narrow as to defeat the exemption’s purpose.”¹²³ The purpose of Section 103 is to provide the states with favorable terms in obtaining capital.¹²⁴ So what would a court look at in our case with the New Jersey *sukuk*? Would it look to the purpose of the state in entering into the *sukuk* arrangement—obtaining capital—or would it look to the mechanism by which it did so—selling the Turnpike and then leasing it back from the buyers? This question, unsatisfyingly, is completely unresolved; the initial buyers of state-issued *sukuk* would have to be willing to bear the risk of having to litigate whether the “rent” payments derived from their securities are excluded from gross income after the *sukuk* issue.

From the buyers’ point of view, this litigation may not be a risk worth taking; indeed, the prospect of a tax exemption may be less relevant than we might initially think. After all, if you are buying *sukuk*, then you are probably trying to avoid *riba* and are not in the conventional market for bonds in the first place. The alternative investment is not conventional bonds, but *sukuk* issued by private entities. Going back to our New Jersey hypothetical, if the primary target of the *sukuk* issue is Muslim New Jersey citizens, they may simply not be interested in litigating the tax issue, since (as noted above) *sukuk* are rather uncommon in the United States today, and New Jersey might well be the only game in town when it comes to low-risk securities.¹²⁵ If the primary target market is foreign investors in the Middle East and South/Southeast Asia, the holders may consider the tax issue worth litigating,¹²⁶ but the worldwide market for *sukuk* is so big

¹²³ *Baltimore Cnty. v. Hechinger Liquidation Trust (In re Hechinger Inv. Co. of Del.)*, 335 F.3d 243, 259 (3d Cir. 2003).

¹²⁴ *Holley*, 124 F.2d at 911.

¹²⁵ Stocks are generally understood to be permissible to Muslims (although futures and speculation are not), but are of course in a different risk category altogether from bonds and *sukuk*. This implicates another Islamic principle, avoidance of *gharar* (undue risk), which is not our subject here.

¹²⁶ There is nothing in the Internal Revenue Code that would exempt foreigners from paying income tax on bonds—or for that matter *sukuk*—issued by U.S. entities, or backed by real property located in the U.S. Moreover, few of the countries with a substantial investor base for Islamic securities have tax treaties with the United States; of all countries with at least nominal majorities of Muslims, only Azerbaijan, Bangladesh, Egypt, Indonesia, Morocco, Tunisia, Turkey, and the former Soviet republics of Central Asia have tax treaties of any kind with the United States (and even then, the treaties may not necessarily provide the relevant tax benefits). DEPT OF TREASURY, IRS PUB. 901: U.S. TAX

that non-exempt state *sukuk* might be passed up in favor of some other investment opportunity outside the United States.

This potentially leaves New Jersey in a bit of a bind. If it sells *sukuk* to its citizens, they might not care enough to litigate the tax implications, but the foreign investors who have the serious money that might be necessary to make a *sukuk* issue worthwhile and who do have an incentive to litigate the consequences also have the resources to put their money somewhere else. The state would probably have to consult with tax authorities. They may also want to get a Private Letter Ruling (PLR) from the Internal Revenue Service (IRS), if possible, in order to give an inkling about whether the IRS would regard the “rent” as exempt or non-exempt; however, even a PLR would be of limited value, since if it rules the “rent” to be non-exempt, that may discourage the markets enough to prevent a sale, and if it rules the “rent” to be exempt, it will not be a final determination of the case and will not necessarily prevent the issue from entering expensive litigation.

This would not necessarily be the end of the line for the state, of course. However, New Jersey would in all likelihood be forced to charge a higher “interest rate” in its first issue, as the tax risks to buyers associated with this first *sukuk* issue will be substantially higher. The question then becomes whether the state would be willing to take this hit at the outset in order to be able to make more favorable *sukuk* issues later. That itself depends on whether the state has any interest in issuing *sukuk* in the future. Put differently, the state must realize that in order to make issuing *sukuk* worthwhile, it may have to commit itself not to one experimental *sukuk* issue, but to making *sukuk* a consistent, if potentially small, part of its overall financing strategy.

B. Bankruptcy Implications

Another concern that both buyers and issuers of state *sukuk* may have is the handling of these financial instruments in bankruptcy, and more generally, in the law of debtor and creditor. Since the purpose of *sukuk* (in the *ijarah* form, at any rate) is to use an equity transaction to simulate the effects of a debt transaction, one would expect there to be a substantial difference between *sukuk* and conventional bonds. However, that may not be the case.

TREATIES 58-59 (2013). Notably absent from this list are the major Islamic-finance money centers of the Persian Gulf and Malaysia.

Directing our attention to bankruptcy, we can identify two scenarios in which *sukuk* may be at issue in bankruptcy: one where the debtor is a *sukuk* holder, and one in which the debtor is a *sukuk* issuer. In the former case, it is unclear that the holding of *sukuk* will have any effect. *Sukuk* are unquestionably an interest in property, and being property of the debtor, would become property of the bankruptcy estate upon filing of the bankruptcy petition.¹²⁷ After that, they would be treated like any other property of the estate; for instance, in a Chapter 7 liquidation, there is no reason to believe that the *sukuk* would not be treated like any other security that is property of the estate: sold to pay the debtor's creditors.¹²⁸

The real legal question arises when the party that *issued* the *sukuk* is the debtor. In our New Jersey Turnpike hypothetical, this is an impossibility; under the Bankruptcy Code, states cannot be debtors.¹²⁹ So for our purposes, we will have to assume that instead of New Jersey, it is a municipality—say, Paterson—which has issued the *sukuk*. Since Paterson does not own the Turnpike, we must also substitute the backing asset; since the Paterson Parking Authority is on a reasonably sound financial footing,¹³⁰ using its assets (garages, parking lots, etc.) to back a municipal *sukuk* issue would mitigate Islamic suspicions of a “sham” asset.

Municipalities are entitled to seek bankruptcy protection under Chapter 9 of the Bankruptcy Code.¹³¹ Although municipal bankruptcies have historically been rare, recent events have made them perhaps more likely than historically believed; most prominently, the City of Detroit—of which Dearborn (another major Muslim center) is incidentally a major suburb and immediate neighbor—filed for Chapter 9 protection in the Eastern District of Michigan in July 2013, and was only the largest of several municipalities to file in the past two years.¹³² Therefore,

¹²⁷ 11 U.S.C. § 541 (2012).

¹²⁸ As both conventional bonds and *sukuk* are securities, there is no difference between the treatment of the former and the treatment of the latter under the Bankruptcy Code; neither can generally be exempted from the estate, at least not under the federal exemptions. 11 U.S.C. § 522(d) (2012). State exemptions may differ, but that is such a complex issue that we will not enter it in this general article.

¹²⁹ See 11 U.S.C. § 101(13), (27), (41) (2012) (definitions of “debtor,” “governmental unit,” and “person.”).

¹³⁰ See *Financial Statement: Years Ended December 31, 2012 and 2011*, PATERSON PARKING AUTHORITY, available at http://www.patersonparking.org/Financials_12-31-12.pdf.

¹³¹ See 11 U.S.C. §§ 103, 109 (2012).

¹³² Michelle Fleury, *Detroit Becomes Largest U.S. City to File for Bankruptcy*, BBC NEWS (July 19, 2013, 11:35 AM EDT), <http://www.bbc.co.uk/>

although unlikely, the prospect of the issuer's default and bankruptcy may be a factor (albeit a minor one) for prospective purchasers of municipal *sukuk*, and therefore their handling in bankruptcy is worth brief consideration.

The main difficulty with *sukuk* using the structure examined (modern *ijarah* securities backed by real estate) is that unlike typical secured bonds, *ijarah sukuk* are purely equity transactions. The issuer continues to hold legal title to the asset on which the *sukuk* are based, in trust for the special-purpose vehicle (which holds beneficial title), and then leases the asset back from the SPV. Of course, lease-and-buyback is not exactly alien to American courts, but the particular circumstances in which this happens in a government *sukuk* issue raises particular issues.

For one thing, unlike most business *sukuk* issuers, governments generally do not back their *sukuk* with property of much inherent value. Marginal vacant land, roads, government buildings, and so on tend not to have much resale value; even if they have some use, the only customer likely to want these properties is the government itself. Our ongoing hypothetical is backed by the New Jersey Turnpike, and our hypothetical on the municipal level is backed by Parking Authority facilities, which are actually profitable, or at least revenue-generating; this cannot be said of everything municipalities might use to back *sukuk*. Moreover, even those assets that do generate revenue often have good policy reasons for being government-held—toll roads and public parking, for instance. One thing both the *sukuk* holders (or indeed holders of a secured conventional bond) and the municipality in any given Chapter 9, is that the holders usually do *not* want to own the underlying asset; a circumstance in which they do is one in which things have gone terribly wrong. But unlike a typical secured bond, where the collateral remains in the possession of the debtor and a deal can be worked out, when a *sukuk* issuer stops paying its “rent,” the *sukuk* holders *already* own the asset.

What this means in a bankruptcy context is that although the *sukuk* holders will be creditors of the municipality, they will not be considered secured creditors; they will instead be unsecured contract creditors. To illustrate, if the City of Paterson were to issue *sukuk* backed by parking infrastructure, and then encounter a financial crisis, default, and file for bankruptcy, its obligations to the *sukuk* holders will be in the form of future rent for the parking structures, not loan payment. Paterson will still owe them, but

because their claim is under the rental contract and does not impose a lien, but rather grants the holders equitable title outright, it will not be a secured claim.¹³³ This places the *sukuk* creditors in a very bad situation, indeed. In a Chapter 9 proceeding, the debtor—i.e. the municipality—must group the claims against it into classes according to whether the claimants are “similarly situated;”¹³⁴ when the debtor presents its Chapter 9 plan, it must be “fair and equitable” to each class of claim in order to be confirmed by the Court.¹³⁵ With respect to a secured claim, this in essence means that the creditor will receive the full value of the property it secures—but not necessarily the property itself, so long as it retains the lien on the property.¹³⁶ To turn back to our example, if the City of Paterson had taken out a conventional loan from a bank secured by one of its parking garages, it would be able to structure its Chapter 9 plan so as to retain the garage, so long as it paid the bank the value of garage and preserved the lien. However, if it had issued *sukuk* backed by the garage, the *sukuk* holders, being unsecured, would not be entitled to this protection. Instead, the City of Paterson needs only to ensure that no class junior to the class containing the *sukuk* holders’ claims is receiving any payment.¹³⁷ And under Section 901 of the Bankruptcy Code, the only unsecured claims of higher priority than any others are administrative expenses of the estate.¹³⁸

What this means for our *sukuk* holders is that, to put it bluntly, they get the short end of the stick. Since nobody is junior to their class, the city could, in a bankruptcy, pay their class a very small amount—maybe even pennies on the dollar—and have the plan confirmed.¹³⁹ To be sure, the *sukuk* holders still have their equitable title to the garage—but what is *that* worth? Moreover, the city may now be short a garage—a very important public utility. In other words, a municipal bankruptcy is far worse for

¹³³ See 11 U.S.C. § 101(37), (51) (2012) (definition of “lien” and “security interest”) and 11 U.S.C. § 506 (2012) (“Determination of secured status.”).

¹³⁴ 11 U.S.C. §§ 901(a), 1122(a) (2012).

¹³⁵ 11 U.S.C. §§ 901(a), 1129(b)(1) (2012).

¹³⁶ 11 U.S.C. §§ 901(a), 1129(b)(2)(A) (2012).

¹³⁷ 11 U.S.C. §§ 901(a), 1129(b)(2)(B)(ii) (2012).

¹³⁸ 11 U.S.C. §§ 901(a), 507(a)(2) (2012). Because municipalities have no equity stakeholders, general unsecured creditors hold the lowest possible priority.

¹³⁹ Exactly how much the *sukuk* creditors would get would depend on the vote of the members of the class of claims containing the *sukuk* claims; a class not receiving full payment is deemed to have accepted the plan if the creditors holding a simple majority of claims, which claims constitute at least two-thirds of the total value of the claims in the class, accept the plan. 11 U.S.C. § 1126(c) (2012).

both the holders of *sukuk* and the municipality than the conventional alternative.

Since the risk of municipal bankruptcy is low—even for a troubled city like Paterson—the need to account for this catastrophe in the “principal” amount or the “interest rate” is also low. But if the unthinkable were to happen, the *sukuk* holders and the city would need to figure out a means for the city to get back its garage and the *sukuk* holders to get reasonable repayment. In theory, the claims-classification and plan-confirmation process could allow for a negotiated solution—since the *sukuk* holders have the garage, they will have some leverage in getting repayment from the city, and it is distinctly possible that the city will put the *sukuk* holders in a class of their own, providing them with further leverage. But even then, such an arrangement, being the product of negotiation, may still put the *sukuk* holders at a disadvantage relative to conventional secured creditors; they may still not realize as much as if they had held a conventional secured claim.

In order to avoid the prospect of negotiating for a potential increase in the amount they receive by holding the underlying asset hostage, the *sukuk* holders may ask that the *sukuk* arrangement be recharacterized as a secured claim, and themselves as secured creditors. As sale-and-leaseback has some niche uses outside of Islamic finance, recharacterization is often requested in cases where such an arrangement is at issue; whether or not recharacterization is granted is somewhat inconsistent and highly fact-based.¹⁴⁰ In the Bankruptcy Courts, a purported lease may be recharacterized as a mortgage (i.e. a secured loan) if it is not a “true lease” as a matter of economic substance.¹⁴¹ In a case under the Bankruptcy Code, a court will look at whether a transaction structured as a lease was intended to operate as a lease in economic terms, or if it is actually a financing transaction.¹⁴² The factors to consider in determining if a transaction is a “true lease” or a financing transaction are grounded in state law and therefore vary from state to state.¹⁴³ However, a few common ones—including the intent of the parties,

¹⁴⁰ John C. Murray, *Recharacterization Issues In Sale-Leaseback Transactions*, PROBATE & PROPERTY, Sept.-Oct. 2005, at 18, available at http://www.americanbar.org/content/dam/aba/publishing/probate_property_magazine/rppt_mo_premium_rp_publications_magazine_2005_so_SeptOct05_Murray.athcheckdam.pdf.

¹⁴¹ *United Airlines, Inc. v. HSBC Bank USA, N.A.*, 416 F.3d 609, 612 (7th Cir. 2005).

¹⁴² *Id.* at 614–15.

¹⁴³ *Id.* at 615–16.

the circumstances of the transactions, the unusualness of the transaction, the adequacy and manner of payment of consideration, the continued exercise of ownership privileges by the seller-lessee, written evidence of debt, and whether rental payments are structured as an investment—all militate in favor of recharacterizing a *sukuk* transaction as a secured loan in the bankruptcy context.¹⁴⁴

On the other hand, some who purchase *sukuk*, who are more concerned about religious doctrine than money, may be displeased with this outcome. They may regard the recharacterization of the *sukuk* as a conventional debt obligation to imply that the payments they have received are interest, and therefore Islamically impermissible *riba*. It would be in their religious interest for a court to deny recharacterization in such a circumstance. One bankruptcy court has in fact used this as a consideration in denying recharacterization in a private *sukuk* issue, regarding the Islamic intent to avoid interest as a part of the intent of the parties in the transaction.¹⁴⁵ This line of thinking may raise some entanglement issues, although again it is possible that proper reliance on individual clerics or clerical organizations may prevent these issues from arising; in any case, it is not immediately clear that the *wishes* of some of the *sukuk* holders will trump the “economic reality” doctrine applied in the courts. What this means going forward, of course, is unclear, except for this: all things considered, *sukuk* buyers should be fully aware of the potential difficulties they might face in the event of a municipal bankruptcy, and municipal *sukuk* issuers should be forthright about the way things might play out in the event of disaster.

IV. SOME CONCLUSIONS

Islamic finance is a fast growing and often confusing industry, with many opportunities for both those seeking financing and those seeking a good investment. However, it is apparently religious character—and definitely religious motivation—can raise

¹⁴⁴ Murray, *supra* note 140, at 19.

¹⁴⁵ Kristen Stilt, *Islamic Finance: Bankruptcy, Financial Distress, and Debt Restructuring: A Short Report*. HARVARD LAW SCHOOL ISLAMIC LEGAL STUDIES PROGRAM (Sept. 26, 2011), available at <https://uaelaws.files.wordpress.com/2012/09/islamic-finance-bankruptcy-financial-distress-and-debt-restructuring.pdf>.

However, it did not do so in a reported opinion, and in any case the *sukuk* were issued as a *musharaka* (partnership) transaction, not an *ijarah* one like the sovereign *sukuk* examined here. *Id.*

suspensions. Some of these suspicions are hysterical nonsense; others, however, might have serious implications in our constitutional order. These are worth addressing and considering. For example, discussion of the crucial problem of reconciling the constitutional mandate not to interfere in religious affairs with the construction of an orderly system for regulating *sukuk*, public or private, is needed to outline a way forward on that critical front—or to see if there is a way forward at all.

However, the state issue of *sukuk* does not raise such deep questions about the relationship between state and religion—at least, it does not raise these questions any more than buying a kosher brisket for the Governor’s dinner does. The constitutional concerns that government-issued *sukuk* might raise are minimal, and very likely to be adjudicated in favor of the program. The only real constitutional question is the permissibility of federal regulation of *sukuk*. But even then, the lack of regulation is for government *sukuk* issuers simply is an additional cost of doing business in this market—if it even factors into the government unit’s decision, given that securities regulation is generally not a problem for state and municipal bond issuers.

In the end, the main obstacles to state-issued *sukuk* in the United States are practical: the obstacle of politics, and the obstacle of whether issuing *sukuk* would be a good idea in the first place. As I hope the discussion of tax and bankruptcy implications shows, states and municipalities contemplating issue of *sukuk* are more likely to be concerned with these practical matters—which determine whether or not *sukuk* are a good strategy for raising money—than the constitutional issues.

For at the end of the day, despite their origin in religious law, *sukuk* are about one thing, and one thing only: business. They were created to facilitate financing in societies operating under the strictures of Islamic law; today, they create opportunities for people not subject to those strictures to do business with people who are. But in any era, and on either side, the basic goal is the same: to make the best deal possible. And if Islamic finance—public or private—is to have a future in the United States, it is the legal issues that keep parties to Islamic transactions from obtaining the best deal possible that should form the real focus.